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Final FDII Regulations: License of IP to Foreign Persons for Foreign Use

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Royalty income derived by a U.S. corporation from licensing intangible property generally is subject to a 21% U.S. federal income tax rate. Section 250(a), however, currently provides a 13.125% effective tax rate for royalty income that is foreign-derived intangible income (FDII).[1]

Income eligible for the lower effective tax rate is referred to as foreign-derived deduction eligible income (FDDEI).[2] In relevant part, such income generally includes royalties from licensing intangible property to a person who is not a United States person, for use not within the United States (i.e., an ''FDDEI sale'').[3]

Final regulations provide detailed rules for determining when income derived by a domestic corporation from licensing intangible property is considered as FDDEI.[4] They also provide substantiation requirements that must be satisfied for royalties to qualify as FDDEI.[5]

More specifically, the final regulations define the term ''FDDEI sale'' to mean a sale of general property or intangible property to a recipient that is a foreign person and that is for a foreign use.[6] The term ''sale'' as used throughout the FDII regulations generally includes a *license* of intangible property.[7]

''General property'' generally means any property other than intangible property, e.g., tangible goods.[8] ''Intangible property'' is broadly defined as including patents, know-how, copyrights, trademarks, trade names, goodwill, and similar property (but not copyrighted articles).[9]

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[1] The 13.125% tax rate applies to gross FDII reduced by deductions (including foreign income taxes) properly allocable to the FDII, and further reduced by 10% of the aggregate basis in depreciable tangible property that gives rise to the FDII. §250(a)(1)(A), §250(b)(1), §250(b)(2), §250(b)(3); Reg. §1.250(b)-1, §1.250(b)-2. *See* §250(a)(2) and Reg. §1.250(a)-1(b)(2) (taxable income limitation).

All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[2] Reg. §1.250(b)-1, §1.250(b)-3. FDDEI does not include income attributable to a foreign branch. §250(b)(3)(A)(i)(VI) (cross-referencing §904(d)(2)(J)); Reg. §1.250(b)-1(c)(11), §1.250(b)-1(c)(15)(vi), §1.250(b)-1(c)(16).

[3] §250(b)(4); Reg. §1.250(b)-1(c)(12), §1.250(b)-4(b). The lower rate also is available for certain foreign-derived income from selling tangible or intangible property, leasing tangible property, and providing services. §250(b)(4), §250(b)(5)(E); Reg. §1.250(b)-3(b)(16), §1.250(b)-5.

[4] T.D. 9901, 85 Fed. Reg. 43,042 (July 15, 2020). The regulations generally apply to taxable years beginning on or after January 1, 2021, but can be relied on for taxable years beginning on or after January 1, 2018. Reg. §1.250-1(b). For an analysis of the rules in proposed FDII regulations concerning royalties, see Yoder, *The Proposed FDII Regulations: Foreign Use of IP*, 48 Tax Mgmt. Int'l J. 227 (May 10, 2019).

[5] *See* Reg. §1.250(b)-4(d)(3)(iv).

[6] Reg. §1.250(b)-1(c)(8), §1.250(b)-4(b).

[7] Reg. §1.250(b)-3(b)(16); *see* §250(b)(5)(E). The term ''sale'' also includes a transfer of intangible property in which gain or income is recognized under §367. Reg. §1.250(b)-3(b)(16), §1.250(b)-4(d)(2)(iv)(B)(8) *Ex.* 8. *See* §367(d); Reg. §1.367(d)-1, §1.367(d)-1T. *See* Yoder, *Code Sec. 367(a) & (d) After the TCJA*, 45 Int'l Tax J. (Nov.-Dec. 2019).

[8] Reg. §1.250(b)-3(b)(10).

[9] Reg. §1.250(b)-3(b)(11) (incorporates by reference the definition in §367(d)(4) which lists numerous types of intangible property and provides a catch all for ''other item the value or potential value of which is not attributable to tangible property or the services of any individual''). Copyrighted articles (as defined in Reg. §1.861-18(c)(3)) are considered as general property for pur-

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A license of intangible property qualifies as an FDDEI sale only if the recipient (*i.e.*, the licensee) is a *foreign person* (*i.e.*, a person who is not a U.S. person).[10] The final regulations provide a presumption that a license of intangible property is to a foreign person if the licensee's billing address is outside the United States.[11] The presumption does not apply if the licensor knows or has reason to know that the licensee is not a foreign person.[12]

In addition, a license of intangible property to a foreign person qualifies as an FDDEI sale only if the property is licensed for a *foreign use*.[13] A license of rights to exploit intangible property solely outside of the United States is for a foreign use.[14] The location of the exploitation of intangible property is determined based on revenue earned from ''end users'' by reference to their location, i.e., within or outside the United States.[15]

Different rules are provided for determining the end user and the revenue generated from the end user depending on whether the intangible property is used in connection with a sale of general property or consists of a manufacturing method or process.[16] The rules also vary depending on whether the foreign licensee is an unrelated or a related party.

If the intangible property is embedded in general property that is sold, or is used in connection with a sale of general property, then the end user of the intangible property is the end user of the general property.[17] Thus, the royalties are for a foreign use to the extent the sale of the general property is considered for a foreign use. This requires identifying the general property associated with the licensed intangibles and determining the location of the person who uses or consumes the general property under the rules that apply for that purpose.[18] For example, a license of trademarks to a foreign person for products that are manufactured and sold to customers located outside the United States would be for a foreign use.[19]

With annual royalties (i.e., periodic payments) arising with respect to intangibles used in connection with general property, the extent to which the royalties are for a foreign use of intangible property generally is determined annually based on the actual revenue earned by the recipient from any use of the intangible property for the taxable year in which the royalties are received.[20] The amount of revenue is the amount derived by the licensee from selling the relevant general property associated with the intangible property.[21] If actual revenue earned by the recipient from selling general property associated with the intangible property cannot be obtained after reasonable efforts, then estimated revenue earned from the use of the intangible property by a recipient that is not a related party may be used based on the rules that apply to lump-sum payments, i.e., based on projected revenue from the sale of general property associated with the intangible property.[22]

The regulations illustrate this rule with a domestic company (''DC'') licensing a copyright to composition A to an unrelated foreign party (''FP'') in exchange for annual royalties of 60% of FP's revenues from sales of composition A. During the taxable year, FP earns $100x from selling composition A, of which

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poses of the FDII regulations. Reg. §1.250(b)-3(b)(10), §1.250(b)-3(b)(11). *See* Yoder, *U.S. Taxation of 'Intangible Income'*, 46 Int'l. Tax J. 3 (Jan.-Feb. 2020) (summarizes and compares the FDII, GILTI and §367(d) regimes for taxing ''intangible income'').

[10] Reg. §1.250(b)-4(b). A ''recipient'' means a person, including a licensee, that purchases property from a seller. Reg. §1.250(b)-3(b)(14). A ''seller'' means a person, including a licensor, that sells property to a recipient. Reg. §1.250(b)-3(b)(17). *See* Reg. §1.250(b)-3(b)(5) (''foreign person'') and §1.250(b)-3(b)(19) (''United States person'').

[11] Reg. §1.250(b)-4(c). *See* Reg. §1.1502-13(c)(7)(ii)(R) *Ex.* 18 (under the matching rule members of a consolidated group are treated as divisions of a single corporation for purposes of determining the FDDEI of the group).

[12] Reg. §1.250(b)-4(c)(1). The Treasury and IRS rejected a comment requesting an exception for a U.S. taxpayer that enters into a global licensing deal with an unrelated U.S. entity whereby the intermediary is granted the authority to sub-license the intangible property to its foreign subsidiaries. The preamble indicates that the U.S. taxpayer could restructure the global license and enter into separate licenses with the foreign subsidiaries of the other U.S. entity. 85 Fed. Reg. 43,042 at p. 43,053.

[13] Reg. §1.250(b)-4(b). In determining foreign use, the regulations do not adopt the rules for determining whether a royalty is foreign-source or U.S.-source income. *See* Yoder, *Royalties Qualifying for FDII*, 44 Int'l Tax J. 3 (Sept.-Oct. 2018) (discussing sourcing rules).

[14] Reg. §1.250(b)-4(d)(2)(i).

[15] *Id.*

[16] Specific rules for determining the end user are also provided for intangible property used in providing a service and intangible property used in research and development. Reg. §1.250(b)-4(d)(2)(ii)(B), §1.250(b)-4(d)(2)(ii)(D), §1.250(b)-4(d)(2)(iv)(B)(12) *Ex.* 12, §1.250(b)-4(d)(2)(iv)(B)(13) *Ex.* 13.

[17] Reg. §1.250(b)-4(d)(2)(ii)(A).

[18] Reg. §1.250(b)-4(d)(1).

[19] For a discussion of the rules for determining the foreign use of general property, see Yoder, *The Final FDII Regulations: Sales of Products to Foreign Customers for Foreign Use*, 49 Tax Mgmt. Int'l J. 11 (Nov. 6, 2020).

[20] Reg. §1.250(b)-4(d)(2)(iii)(A). Different rules are provided for lump-sum royalties that are based on revenue projections. Reg. §1.250(b)-4(d)(2)(iii)(B).

[21] If a licensee does not earn any revenue during the year from selling general property associated with the intangible property, the royalty for that year would not be FDDEI. *See* Reg. §1.250(b)-4(d)(2)(iv)(B)(13) *Ex.* 13.

[22] Reg. §1.250(b)-4(d)(2)(iii)(A). The final regulations eliminate the requirement in the proposed regulations that estimated revenue be determined on an annual basis. 85 Fed. Reg. 43,042 at p. 43,060.

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$60x is from customers located in the United States and $40x is from customers located outside the United States. DC earns a royalty of $60x ($100x x 60%), and $24x ($60x × 40%) is FDDEI gross income.[23]

The preamble states that where the licensed intangible property is legally protected (as is the case with patents and trademarks), the location in which the legal rights to the intangible property are granted and exploited generally determines the location of the end users. For example, in the case of patents that provide rights only for markets outside the United States, the end users will generally be located solely outside the United States.[24]

A similar treatment should apply where the license expressly provides that the intangible property can be exploited solely outside the United States.[25] In addition, the license of intangible property will be considered for foreign use if the taxpayer obtains credible evidence from the licensee establishing that the revenue for the taxable year was derived only from exploiting the intangible property outside the United States.[26] As discussed above, foreign use of intangible property associated with general property is determined based on the foreign location of the end user of the general property.

A special rule applies for determining foreign use for intangible property that consists of a manufacturing method or process, and that is licensed to a foreign unrelated party.[27] In this case, the foreign unrelated party that licenses the intangible property is treated as the end user and as located outside the United States.[28] The revenue earned from the end user is the royalties received from the licensee, and thus all of the royalties would be FDDEI.[29] While this rule generally would not be available for royalties derived from licensing a manufacturing method or process to a foreign related party, it does apply if the foreign related party licenses such intangible property to a foreign unrelated party.[30] This special rule does not apply if the seller knows or has reason to know that the manufacturing method or process will be used in the United States, in which case the foreign unrelated party is considered as the end user and as located in the United States.[31]

A license of intangible property to an unrelated party will also be for a foreign use if the licensor uses the intangible property to manufacture components that are used to manufacture products outside the United States. For example, a domestic corporation licenses the worldwide rights to patents to a foreign unrelated person to make silicon chips, and the patent does not qualify as a manufacturing method or process. The silicon chips are sold to another foreign party and used to manufacture computers outside the United States.[32] The entire amount of the royalty qualifies as FDDEI based on the location of the manufacture of the computers, even if the computers are sold to U.S. customers as well as to foreign customers.[33]

The final regulations do not treat a related person that uses general property in manufacturing a product

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[23] Reg. §1.250(b)-4(d)(2)(iv)(B)(1) *Ex.* 1.

[24] 85 Fed. Reg. 43,042 at p. 43,057. If the licensed intangibles are legally protected both within and outside the United States, then the rules described in the text above for determining foreign use of the intangible property would need to be applied.

[25] *See* Reg. §1.250(b)-4(d)(3)(iv)(A).

[26] Reg. §1.250(b)-4(d)(3)(iv)(B).

[27] A manufacturing method or process refers to such intangibles as patents and know-how consisting of a sequence of actions or steps that comprise an overall method or process that is used to manufacture a product. Reg. §1.250(b)-4(d)(2)(ii)(C)(3).

[28] Reg. §1.250(b)-4(d)(2)(ii)(C)(1), §1.250(b)-4(d)(2)(ii)(C)(3). This rule does not apply if the intangible property is used by the foreign unrelated party to manufacture products on behalf of the licensor or a party related to the licensor. Reg. §1.250(b)-4(d)(2)(ii)(C)(2).

[29] Reg. §1.250(b)-4(d)(2)(iii)(C); *see* Reg. §1.250(b)-4(d)(2)(iv)(B)(5) *Ex.* 5 and §1.250(b)-4(d)(2)(iv)(B)(6), *Ex.* 6.

[30] The rule applies to the license of a manufacturing method or process to ''a foreign unrelated party (including a [license] by a foreign related party). . . .'' Reg. §1.250(b)-4(d)(2)(ii)(C)(1). *See also* 85 Fed. Reg. 43,042 at p. 43,058 (''The manufacturing method or process rule applies only to sales to unrelated parties (including sales made through related parties that ultimately result in a sale of the manufacturing method or process to an unrelated party).''). The special use rule would not apply to a license of a manufacturing method or process to a foreign related party that licenses the intangibles to a foreign unrelated party where the foreign unrelated party uses the intangible property to manufacture products on behalf of the foreign related party. Reg. §1.250(b)-4(d)(2)(iv)(B)(7) *Ex.* 7.

[31] Reg. §1.250(b)-4(d)(2)(ii)(C)(1). If a license includes rights to use a manufacturing method or process and rights to use other intangible property in connection with the sale of general property, the amount of royalties received must be bifurcated between the two types of intangible property based on §482 principles and the separate foreign use rules applied to the respective portions of the royalties. Reg. §1.250(b)-4(d)(2)(iii)(C); *see* Reg. §1.250(b)-4(d)(2)(iv)(B)(6) *Ex.* 6.

[32] The Treasury and IRS rejected a comment requesting that certain product intangibles be treated as a component of a finished product and provide a rule analogous to the rule treating physical components as used outside the United States if incorporated into another product at a location outside the United States. 85 Fed. Reg. 43,042 at p. 43,059; *see* Reg. §1.250(b)-4(d)(1)(iii)(A) and §1.250(b)-4(d)(1)(iii)(C). Thus, in the example the end user is not the manufacturer of the silicon chips.

[33] Reg. §1.250(b)-4(d)(2)(iv)(B)(9) *Ex.* 9. On the other hand, if the unrelated foreign party manufactured the computers in the United States, none of the royalties would be for a foreign use of the intangible property. Reg. §1.250(b)-4(d)(2)(iv)(B)(11) *Ex.* 11.

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as a foreign use.[34] Thus, if in the above example the silicon chips were used by a related party to manufacture computers, the location of the end user of the computer would need to be determined for purposes of determining the location of use of the intangible property. For example, if the computers were sold by a related party to wholesalers who only sold to retailers located outside the United States, all of the royalties would be for foreign use of the intangible property.[35] In addition, if in the above example a related foreign party manufactured and sold the silicon chips to an unrelated party that used the chips to manufacture computers outside the United States, then all of the royalties would be for a foreign use of the intangible property.[36]

A license of intangible property will be treated as an FDDEI sale only if substantiation requirements are satisfied with respect to the foreign use of the property.[37] Under the regulations, foreign use may be established with a binding contract that specifically provides that the intangible property can be exploited solely outside the United States.[38] The substantiation requirement can also be met with credible evidence obtained or created in the ordinary course of business from the recipient establishing the portion of its revenue for a taxable year that was derived from exploiting the intangible property outside the United States.[39]

In sum, royalties earned by a domestic corporation from the license of intangible property to an unrelated or related foreign person for use outside the United States generally qualify for an effective tax rate of 13.125%. Under the final regulations, royalties for the license of intangible property for use in connection with the sale of inventory generally satisfies the foreign use requirement if the purchaser of the general property is located outside the United States. Foreign use generally is presumed if the legal documents provide that the intangible property can only be exploited outside the United States. In addition, the royalties from the license of a manufacturing method or process to a foreign unrelated party (including through a foreign related party) will generally be treated as for a foreign use. The final regulations require documentation of the foreign use of the intangible property that is prepared at the time the tax return is filed.

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[34] *See* Reg. §1.250(b)-4(d)(1)(iii).

[35] *Id.*

[36] Reg. §1.250(b)-4(d)(2)(iv)(B)(10) *Ex.* 10. The seller must substantiate that the foreign purchaser will use the property in manufacturing operations outside the United States. Reg. §1.250(b)-4(d)(3)(iii).

[37] Reg. §1.250(b)-4(d)(2)(i) (penultimate sentence). The substantiation documents must be in existence as of the FDII filing date with respect to the FDDEI transaction. Reg. §1.250(b)-3(b)(3), §1.250(b)-3(f)(1).

[38] Reg. §1.250(b)-4(d)(3)(iv)(A).

[39] Reg. §1.250(b)-4(d)(3)(iv)(B). A written statement prepared by the licensor with corroborated evidence supporting the foreign use of the intangible property also can be relied on to satisfy the substantiation requirement. *See* Reg. §1.250(b)-4(d)(3)(iv)(C)(1)-(9) (containing the information needed to be corroborated).

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